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CONTAGEM

The voters in Brazil's elections on October 1st can look back on welcome help for the dispossessed and forward to the likelihood of little broader reform

AN UNEXPECTED whiff of garlic is the first indication of an industry that helps sustain the 70,000 people of one of the poorer districts of Contagem, a city in eastern Brazil. Elizabete Cordeiro and Romilda da Silva are among the 200 women who spend their days peeling garlic, which fetches more than the unshelled sort in nearby Belo Horizonte. Hunched over plastic buckets outside a brick hovel, they shell 1,000 kilos a month. This yields 400 reais ($185), which they share.

Hard as life is, it has lately improved. Shelling garlic pays more than it did, thanks to a one-third rise negotiated by a local NGO. And a few months ago the women became beneficiaries of the federal government's Family Fund, a stipend of up to 95 reais a month that goes to parents who keep their children at school and take them for medical check-ups. The fund now reaches the poorest quarter of Brazil's population. Mrs da Silva notes that the price of rice has "fallen a lot", another boost to the family budget.

For all this the women credit Luiz Inácio Lula da Silva, the first Brazilian president whose background is as humble as theirs. Accordingly, they will vote for him on October 1st, in the first round of Brazil's general election. And so will many others like them. The man who proclaims the poor to be "every cell" of his body is backed by 57% of the voters who earn up to 700 reais a month, according to Datafolha, a polling firm. Against this bearded Evita, Geraldo Alckmin, a former governor of São Paulo, Brazil's most populous state, has been struggling.

Lula will probably win, in the second round on October 29th if not in the first, because in the eyes of most voters he has kept the promises that matter. While showering money on the poor, he has cut inflation, created jobs and kept the economy growing. Foreign debt no longer hangs over Brazil like the blade of a guillotine. The economy is enjoying "the best fundamental conditions of the past 30 years", boasts Antonio Palocci, a former finance minister who is now a congressional candidate for Lula's Workers' Party.

And yet Brazil is not as sound as Lula's popularity ratings. Economic growth has been slow by comparison with other countries in Latin America, and with the three "BRIC" countries—Russia, India and China—the less-developed world's leading economies (see charts on next page). A big reason for this is a huge public sector, which keeps interest rates high and has only grown more voracious under Lula.

The list of reforms needed to perk up the economy is not much shorter than it was when Lula took office in 2003, and other issues have grown in urgency. Brazil's dismal standard of public education suddenly seems intolerable, prompting the president to campaign on the clunky slogan "development with income distribution and quality in education". And crime moved up the agenda when a prison-based gang in São Paulo started attacking police and public transport in May.

Then there is corruption, which does not worry garlic-shellers but enrages the newspaper-reading elite. Although graft carries no party card, much anger is directed at the ruling party and Lula himself, partly because they were once seen as the holders of the Brazilian patent on political purity. A scandal erupted in May 2005 which involved Lula's closest associates bribing congressmen to back the government. Now the final days of the campaign are being muddied by allegations that Lula's advisers tried to buy a dossier supposedly implicating José Serra, the candidate for the governorship of São Paulo from Mr Alckmin's Party of Brazilian Social Democracy (PSDB), in another scandal. The electoral court could cancel Lula's election if it were proved that he had benefited from wrongdoing. More likely, the scandal could undermine Lula's capacity to govern. The political system itself has become a top election issue.

Efficiency must wait

No saviours are on the ballot. Mr Alckmin is "much more prepared [than Lula] to make the state efficient" and therein lies the big difference between them, says Aécio Neves, the PSDB governor of Minas Gerais, whose re-election is even more certain than Lula's. This rings true. The next president's most urgent task seems impossible: to curb the state's appetite for both resources and economic influence while raising investment and improving services like education.

Lula is not the ideal agent to bring about change. He and his party embody an alliance between the dispossessed and those who benefit from an indulgent state, such as union members and public-sector workers. Some of the government's mistakes can be traced to the false notion that what is good for the one is good for the other, not surprisingly perhaps, given that Lula, born poor, became a union leader.

Tax-and-spend habits were already entrenched when Lula took office, but he has not changed them. Instead, he has turned his attention to social policy. While suppressing inflation and containing the deficit, he has transferred more cash to households, partly through the Family Fund, which helps the poor, but also through increases in the minimum wage, which raises publicly financed pensions. The upshot is that the central government's current spending is set to rise from 16.9% of GDP in 2003 to 19% this year, says Raul Velloso, a specialist in public finances.

The mix of subsidy and stability, though, has done wonders for the poor. The poverty rate, as measured by the Getulio Vargas Foundation, a business school, fell from 28% of the population in 2003 to 23% last year, which was comparable to the improvement brought about by the end of hyperinflation in the early 1990s. Lula's critics carp that the Family Fund merely alleviates poverty without providing an exit. That is to underestimate the value of reducing misery. The trouble is that although the total real income of Brazil's poorest households rose 28% between 2004 and 2005, that of the middle class increased just 1.6%.

Well-being in Lula's Brazil is unevenly spread in geographic terms, too. Cash transfers have animated the economy of the poor north-east, where retail and wholesale trade jumped 15.6% in the year to July. But this will tail off when the government ratchets back increases in handouts, as it must. In the southern state of Rio Grande do Sul, the economy shrank 5% last year because of drought, which hurt farming, and the strong real, which damaged industries such as shoe- and furniture-making. The economy of Rio de Janeiro, the second-largest city, has not grown since 1975. Enterprise there is thwarted by bureaucracy and high taxes. A third of the income in the metropolitan area comes from pensions.

As Rio's stagnation suggests, the blame must be shared by earlier administrations and all levels of government. But Lula has done too little to spark higher growth. Investment, the best indicator of the economy's long-term health, has edged up from 18% of GDP in 2003 to 20%, not enough to sustain growth rates of more than 4%. Lula promises that investment will rise to 25% of GDP in his second term, but how?

His government has done several useful things, such as passing a bankruptcy law. A long-delayed measure to encourage the private financing of public works may at last yield results. And, after a shaky start, a new model for commissioning power generation is starting to show it can attract private capital to the electricity industry.

Ignore or overrule

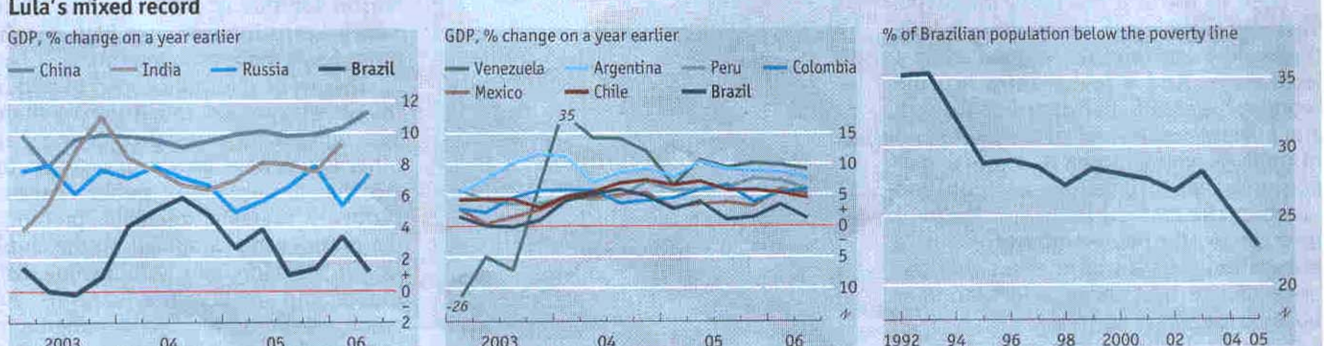
But this is not enough. The central government is responsible for investment amounting to only 0.8% of GDP. Its attitude towards regulatory agencies, whose independence should encourage investment in infrastructure, has bordered on hostility. The telecoms ministry has more than once sought to overrule Anatel, the industry regulator. And investment in sanitation has been stuck at a derisory 0.2% of GDP for the past seven years, leaving a quarter of Brazil's urban population lacking access to sewerage.

The reforms required to boost Brazil's growth are as familiar as old jokes. They include formal independence for the Central Bank, which would allow it to achieve its inflation target with lower interest rates, lower trade tariffs, a simpler tax system and, above all, a long-term plan to reduce spending and the net public debt, which at present stands at about half of GDP. With taxes close to their limit (tax revenue hit a record 37% of GDP last year) and spending rising inexorably, the government will struggle to deliver the primary budget surplus (ie, before interest payments) of 4¼% of GDP that it has promised.

"It's clear this model is almost exhausted," says Marcos Mendes, an economist in Brasília, the capital. A better one would, among other things, give the government more discretion over spending, 90% of which is tied to items like pensions and health, and breaking the link between the minimum wage and pensions. All would inflict political pain.

Brazilians wonder whether new models can be built with the same old politics. Mr Alckmin, a tax-cutting technocrat who has run an uninspired campaign short on

Lula's mixed record



Sources: National statistics; Thomson Datastream; Getulio Vargas Foundation detail, might just do better. But the inertia built into Brazil's institutions may get the better of any candidate. The 1988 constitution is a busybody document with something to say on everything from the structure of the police to tuition fees at public universities (forbidden). It directs the government to hand about half its tax revenue to the 27 states and 5,500 (often financially incontinent) municipalities. IPEA, a research institute, says they wasted 16 billion reais in 2000, 1.5% of GDP. Many economic reforms require a constitutional amendment that must twice win three-fifths majorities in both houses of Congress. This will hobble any president.

Moreover, many of the issues exercising voters, including crime and education, are the responsibility mainly of the states and municipalities. Much therefore depends on give and take between the president and the other branches and levels of government. The voters this Sunday will elect all state governors and legislatures, the lower house of Congress and a third of the Senate, as well as the president.

Of the 27 states, 19 are expected to re-elect incumbent governors or successors from the same parties. The current Congress is widely seen as the most corrupt in history. The next one may even have a seat for Fernando Collor, a president impeached in 1992, and Mr Palocci, who has been charged with infractions while he was a mayor. Brazil's "presidential coalitionism," in which a directly elected president must fashion majorities from a fragmented Congress, is never easy to manage. Lula's administration has fared worse than most, only grudgingly giving allies top government jobs, which has left bribery as one of the few ways to recruit support. That so many congressmen are eager to succumb—nearly a fifth of the lower house is implicated in some scandal—has something to do with the way they are elected.

The missing link

With 5,406 candidates competing for 513 seats in the lower house, the congressional vote amounts to a mass beauty contest. Few of the aspirants have more than casual contact with their constituents, partly because they represent whole states rather than districts. The system is proportional: the number of votes won by a party or its candidates determines how many seats it gets in each state. Within that quota, the winners are those with the most individual votes, which may not be many.

Over half the voters generally forget which congressmen they have voted for. Winning candidates can, and often do, switch parties after the election, further straining their link with voters. This "deficit of representation" makes it difficult for voters to scrutinise their representatives and for presidents to build stable coalitions. That encourages corruption.

The Family Fund has worked

The answer, many believe, is political reform. One element is already in place. In the next Congress parties will for the first time have to cross a threshold—5% of the national vote—to secure various privileges, including free television time. The number of parties, 16 at present, may be halved. Other reforms may include penalties for politicians who switch parties, public money for campaigning and voting for party lists instead of single candidates.

That would not be a cure-all. Party voting and penalties for party-switching would strengthen parties and citizens' monitoring of their representatives, which ought to reduce corruption. But much of the representation deficit has to do with wider economic and social conditions. A poor and badly educated electorate is unable to control the behaviour of politicians, says Claudio Weber Abramo of Transparência Brasil, an anti-corruption NGO. Designing a new electoral system might distract from the more urgent task of economic reform.

Some Brazilians are not altogether downhearted, though. Their country may be growing more slowly than the other BRIC countries, but its institutions are sturdier, asserts Antônio Delfim Netto, a congressman from the centrist Party of the Brazil Democratic Movement. In Brazil party politics is virtually the only politics, points out Fátima Anastasia, of the Federal University of Minas Gerais, which makes it more stable than such neighbours as Bolivia and Venezuela, where strikers and strongmen hold sway.

Even without reform, the meshing of growth and democracy keeps Brazil moving forward with occasional bursts of speed. That is certainly true in Minas Gerais, where Governor Neves claims to have eliminated the budget deficit and applied a "management shock" to the bureaucracy. "Results agreements" pay bonuses to civil servants in exchange for hitting targets such as cutting the number of prison escapes. "We're gradually changing the mind-set of the civil servant, who used to pass the exam [for his job] and then sit passively in his chair," claims Antonio Anastasia, Mr Neves's running-mate. Mostly hype, sniff his critics, who claim, among other things, that he balanced the books by cutting health spending and cares more about efficiency than ending poverty.

Yet in Contagem Mr Neves's entrepreneurial approach has made a difference. Unlike the *favelas* of Rio de Janeiro, where gun-toting adolescents rule, the poor parts of Contagem were not abandoned by the state. Minas Gerais created special teams of police to patrol violent areas. The notorious Nelson Hungria prison no longer erupts. The state employs nearly 400 people in "social prevention" projects such as Stay Alive, which lures the young away from crime with computer training, football and other activities. And the local monthly murder rate has dropped from double to single digits.

Lula's party is allergic to the idea of management shocks but their spirit is spreading, for example, to education, where it may be needed most. Lula has been rightly skewered for ignoring basic education during his first three years in office, but that seems to be changing. Last year, for the first time, the education ministry tested all primary public schools in urban areas. In June it published the results of the national tests, school by school. Now each will be given its own targets to improve its scores.

Shock treatment needed

To help meet those targets the government intends to distribute an extra 5 billion reais to schools in the ten poorest states. A thousand teacher-training centres are to improve teaching quality. A genuine management shock would allow school directors to choose their teachers and would hold them accountable for the results. Fernando Haddad, the education minister, admits that Brazil is still in the "ante-room" of such a discussion but thinks targets and tools will "change the culture" of education. By 2022, he says, Brazil's scores should be as good as the industrial-country average.

It is indeed possible that the national tests could click with Mr Neves's results agreements and the Family Fund's education requirement to lift young Brazilians into useful work. But if that is to happen quickly, Lula will need to act. He has proposed a national pact for reform after the elections. But the attempt to smear Mr Serra threatens to disrupt his second term before it begins. The price could be four more years of underperformance. ■

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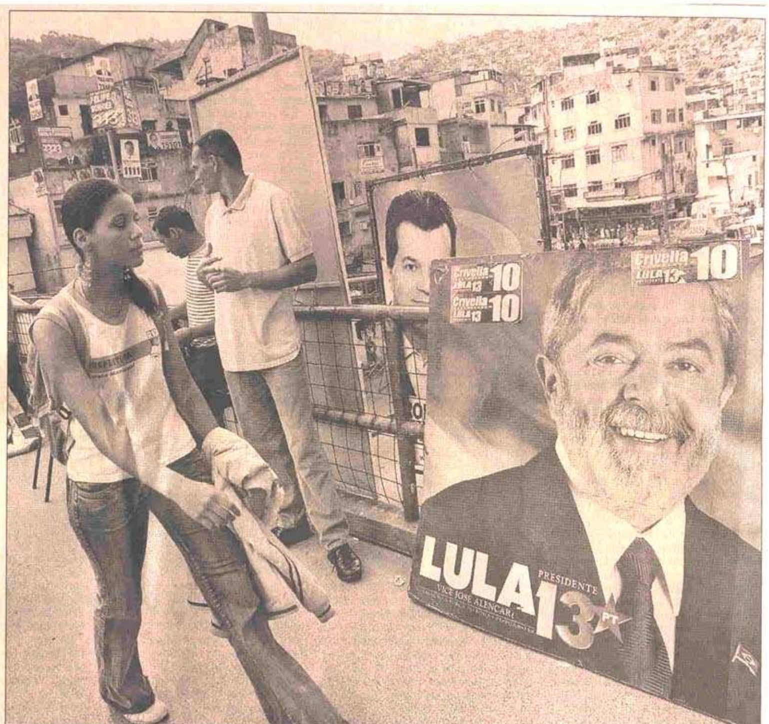
LATIN AMERICA

The Lula bonanza – how reform is eluding a more prosperous Brazil

Hand-outs have helped put the president on course for re-election on Sunday but growth is below potential, write **Jonathan Wheatley** and **Richard Lapper**



Feelgood factor: a benign economy and help for the poor, as in Rio's Rocinha slum, have eclipsed the problems of the Luiz Inácio Lula da Silva government AP

João Ferreira leans against the fence surrounding his two-room house – one of a row of simple properties on a farm outside Coração de Maria in rural Bahia, north-eastern Brazil. "I've never voted for Lula but I will on Sunday," he says. Why? "Prices aren't going up. It used to be that every two weeks everything was more expensive – but not any more."

In nearly four years of President Luiz Inácio Lula da Silva's left-leaning government, low inflation is not the only improvement to Mr Ferreira's life. He and his wife have one 11-year-old son and receive R$65 ($30, £16, €23) a month from a federal income transfer programme in exchange for keeping him in school.

The Ferreiras are one of 12m families – about 44m people – receiving such benefits under a scheme known as Bolsa Família, started under the previous government of the centrist PSDB but quadrupled in size by Mr Lula da Silva since he came to office in January 2003.

Economic stability, the Bolsa Família, a rising national minimum wage, stable and even falling food prices and a dramatic expansion in consumer credit are among the reasons why Mr Lula da Silva appears to be heading for a decisive victory on Sunday in a presidential election that is being held alongside congressional and state polls.

It is not such policies alone that have boosted Mr Lula da Silva's support. Rocketing demand for Brazil's commodity exports from China and other fast-growing economies, low international interest rates and a glut of liquidity on global financial markets have contributed to what is for Brazil an extraordinarily benign international environment. Healthy current account surpluses have allowed Brazil to pay off external debts. The strengthening currency – the Real has gained 60 per cent in value against the US dollar under the Lula administration – has underpinned price stability and benefited the poor.

The feelgood factor has been enough to push the administration's many difficulties into the background. Less than a year ago, the president had been written off as no longer electable after a series of corruption scandals culminating in the so-called *mensalão* affair, under which senior members of his government and the PT, his party, were accused of bribing legislators.

It has also distracted attention from a potentially much greater problem: Brazil's failure to achieve fast and sustained growth. The economy is expected to expand by just 3 per cent this year – short of the government's target of 4-4.5 per cent and much less than the country needs to overcome its social problems.

So far, however, this has had little impact on voters. His main rival, Geraldo Alckmin of the PSDB, is still hoping to force a second-round run-off but polls show Mr Lula da Silva is likely to win the majority needed for outright victory. "Lula has been lucky with the international situation," says Ricardo Noblat, a much-read political blogger. "But his social programmes aren't a matter of luck. Put those together with admittedly timid growth and his personal charisma, and they explain why he will win on Sunday."

Ever since his inauguration speech four years ago, Mr Lula da Silva has emphasised his concern for Brazil's poor. Income transfer programmes begun under the PSDB have been vastly expanded: spending has risen from R$2.3bn in 2002 – the last year of the previous administration – to R$8.3bn this year. The number of families receiving benefits from the Bolsa Família has risen from 3.6m in 2003 to 11.1m.

The electoral dividends are particularly evident in the north and north-east, the least developed parts of Brazil and home to one-third of its 180m people and more than half of its poor. In Bahia, the most populous state in the region, the president's support in opinion polls is running at about 70 per cent.

"Of course I'm going to vote for Lula," says Márcia dos Santos, an unemployed mother of one who lives in Lobato, a slum on the outskirts of Salvador, the state capital of Bahia. "He's the one who gives us benefits."

It is a much-heard view across a region that until recently voted for traditional rightwing and populist parties. "Lula has turned the Bolsa Família into the biggest vote-winner in Brazilian history," says Bolivar Lamounier, a political scientist. "The poor electorate of the north-east has been turned captive."

Mr Lula da Silva has won over the poor in other ways, too. With a stronger currency and inflation under control, food prices have actually fallen in the past 12 months. The national minimum wage has increased by 26 per cent in real terms under the Lula government. In 2002 it was enough to buy 1.3 *cestas básicas* – the basic monthly basket of food for a family of four. It buys 2.3 today.

The government has also stimulated consumption through new forms of credit. Payroll-linked lending introduced in 2004, in which instalments are taken straight from borrowers' wage packets, reached a total of R$44.3bn last month.

More generally, stable economic conditions have paved the way for an increase in consumer borrowing, especially in the form of instalment schemes offered by retailers. "Before, it was much more difficult to get credit," says Helinita Santana, who earns R$350 a month as a domestic servant for a middle-class family in Salvador. In the past two years, Ms Santana has bought a 20in television, a DVD player and a refrigerator from Insinuante, a local chain of household goods stores. Ms Santana also says she will vote Lula.

The Lula government has, however, done more than tend to the poor. Four years ago Mr Lula da Silva was anathema to financial markets. Yet by sticking to the orthodox monetary policies and moderately tight fiscal policies of the previous administration, he has produced a sharp reduction in overseas borrowing costs, improved the profile of domestic debt and built up comfortable foreign reserves. Brazil seems certain to achieve investment-grade status – which would allow mainstream US and European institutional investors to buy its assets – by 2008 at the latest, a prospect that should lead to further rises in the prices of outstanding bonds.

While Brazilian financial market investors and entrepreneurs may not have been converted into ardent *Lulistas*, they are happy enough with the status quo not to be agitating for change. High overnight interest rates have helped contain inflation but have also provided unprecedented profits for Brazil's banks and growing band of hedge funds. They have also brought a bonanza for anyone with capital to invest on financial markets.

"Lula is good for the poorest and the richest," says Luiz Carlos Mendonça de Barros, a member of the former government who now runs a hedge fund in São Paulo. "For the financial markets, Lula is wonderful."

But critics warn that the boom times for both rich and poor will come to an end if Brazil's growth rate remains stuck at less than 3 per cent a year. The biggest problem, they say, is Mr Lula da Silva's failure to follow up initial efforts to reform the public sector by trimming spending on public-sector payroll and pensions. His government won praise for being quick to enact much needed reform of the public-sector workers' pensions system in 2003 but has not tackled the INSS, the much more problematic public system for private-sector workers. Spending on the INSS rose from 6.5 per cent of gross domestic product in 2002 to an estimated 7.8 per cent this year – dwarfing the 0.4 per cent of GDP spent on income transfer programmes such as Bolsa Família. Likewise, spending on the public-sector payroll will be 5.1 per cent of GDP this year. Far from trimming payroll spending, the government recently announced plans to increase it by 11.4 per cent next year, well above the rate of inflation.

> The government has been unable to improve public services. Education is almost universal but tuition standards are low

The government counters such criticism by pointing out that it regularly achieves budget surpluses before interest payments of 4.25 per cent of GDP. But the surpluses have been possible only because the tax take has risen in line with public spending. It was about 35 per cent of GDP when Mr Lula da Silva took office and reached 39 per cent this year. That is roughly double the level of competing developing countries and, as Mr Mendonça de Barros says, similar to that of developed countries such as the UK and Germany – which finance comprehensive social welfare provision that Brazilians can only dream of.

"Brazil spends a lot but it spends badly," says Marcelo Neri, director of the social policy unit at the Getúlio Vargas Foundation, a university in Rio de Janeiro. "Policies like Bolsa Família clearly target the poor but they live alongside others that go to the non-poor."

Spending ineffectively also means that the government has less money available for roads, ports, power generation and other physical infrastructure that help promote growth. For the same reason, the government has been unable to improve the quality of public services. Education is almost universal but teaching standards are poor. Regulation, too, leaves much to be desired, with investors frequently complaining of a lack of transparency or arbitrary decisions by officials. Little has been done to ease the complexity of doing business.

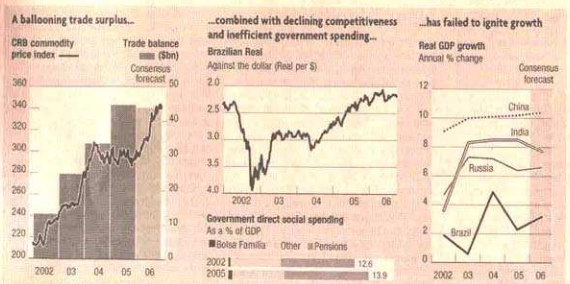
Favourable global conditions have contributed to a lack of urgency over addressing such issues. Yet these conditions are creating new problems of their own. Brazil's enormous trade surpluses of more than $40bn a year, combined with high interest rates and resultant inflows of short-term capital, have contributed to the rapid appreciation of the currency. This in turn has reduced the competitiveness of Brazilian manufacturers. While exports continue to rise, they are increasingly led by iron ore and other commodities with little or no added value. Meanwhile, thousands of companies in sectors such as footwear and textiles have gone out of business.

All these factors help explain why Brazil is sliding down the league table of international competitiveness. According to the World Economic Forum's survey published this month, Brazil ranks as the 83rd most competitive country in the world, nine positions lower than in 2005, and behind all three bigger emerging economies – China, India and Russia – with which it is sometimes compared.

Mr Mendonça de Barros goes as far as describing the current mix of policies as "financial populism". Unlike leaders such as Hugo Chávez in Venezuela, Evo Morales of Bolivia or Argentina's Néstor Kirchner, Mr Lula da Silva is adhering to orthodox macroeconomic policies and has ruled out the kind of price controls or nationalisation favoured by his more radical – some would say traditionally populist – neighbours.

But by failing to take action to encourage greater investment he may be storing up problems for the future, putting short-term concerns over long-term ones.

It is a critique that Mr Alckmin has attempted to articulate, although without achieving much resonance among voters. Mr Mendonça de Barros says that because things have just been going so smoothly, few Brazilians are interested in discussing economic alternatives. "God has helped Brazil," he says, "but maybe it was really the devil."



Sources: Thomson Datastream; Consensus Economics; Central Bank/IPEA